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C O N F I D E N T I A L SECTION 01 OF 03 WARSAW 001843

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TAGS: [EAIR](#) [ECON](#) [PL](#)

SUBJECT: LOT AIRLINE MANAGEMENT ON CHALLENGING POLISH
AVIATION OUTLOOK

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Classified By: EconCouns R.Rorvig for reasons 1.4 (b) and (d).

Summary

1, (C) The Polish air carrier LOT plans to time its initial public offering (IPO) on the Warsaw Stock Exchange with the arrival of the Boeing 787 in summer 2008, according to senior company executives. LOT hopes the PR splash from the new aircraft will create a good buzz with potential investors, who could in theory be allowed to buy up to 49% of the state-owned carrier under existing Polish law. LOT will try to see that the financial period running up to the IPO is a good one, which will require making some adjustments to existing schedules and ticket prices. LOT is currently losing money on its transatlantic flights, due to the high number of discounted tickets sold earlier this year under special promotions. The most profitable routes are to Germany. LOT faces growing competition from discount carriers for Poland's small number of qualified pilots. LOT needs at least 10 new pilots for each new aircraft, while Poland's entire annual output of commercial pilots is 15. LOT is considering partnering with Poland's main flight academy in Rzeszow to double this number. (End Summary)

LOT bets on the Boeing 787

12. (C) During an August 28 breakfast with the Ambassador, LOT Executive VP for Operations and Technical Jerzy Adamski and Executive VP for Finance and Economy Konrad Tyrajski discussed conditions in Poland's aviation market and the outlook for the carrier. Adamski said that the arrival of the Boeing 787 in summer 2008 would be an extremely important event for the carrier. LOT planned to time its long-planned initial public offering on the Warsaw Stock Exchange to take advantage of the publicity from the arrival of the new plane. It is currently thinking about which new routes would feature the aircraft, with a Warsaw-Beijing connection being among the favored options.

13. (C) Adamski said LOT is encountering difficulty in getting Boeing to agree to cabin lay-out changes it would like to introduce in its previously ordered 787 aircraft. LOT would like to increase the seat pitch in its business class section by five inches to allow business class seats to recline to a fully flat position. This is important for passenger comfort on long-distance flights and is increasingly the global standard for business passengers. However, Adamski said Boeing has told LOT that if such

changes are introduced, LOT will lose its place in the 787 delivery queue. LOT's strategy depends on the 787's being delivered on time and in a configuration that will allow the airline to compete effectively for more business traffic. Adamski asked for the Ambassador's assistance in communicating to Boeing how important this request is for the Polish carrier.

LOT Dissatisfied with STAR Alliance

14. (C) Adamski said that LOT's membership in an aviation alliance (STAR Alliance) dominated by much larger international carriers has advantages and disadvantages. Big players such as Lufthansa are able to use LOT as a feeder carrier, but offer little new long-distance traffic in return. Furthermore, LOT's attempt to increase profitability by carrying more business travelers is running into Lufthansa's increasingly aggressive marketing tactics. For example, Lufthansa, which has access to LOT passenger data through the Star Alliance network, subsequently e-mails these travelers with special offers. From a strategic viewpoint, British Air is the best partner for LOT since there is less overlap in the markets. LOT is currently looking at its alliance options and does not rule out a change.

Pilot Shortage

15. (C) Poland faces a growing pilot shortage, due to its small annual output of trained commercial pilots and the arrival of many low-cost carriers. The Air Carrier portion of LOT Airlines currently has 456 pilots and 741 flight attendants in its 3600 person complement. (This does not count other personnel working in LOT's sister ground

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services, fuel, and catering companies.) Since each aircraft requires roughly 10 pilots (4-5 two-person crews), LOT will need at least 50 new pilots to crew the five new 787's of which it expects to take delivery in the next year or two. Poland's market is currently swept clean of pilots. Other EU carriers such as Ryan Air are hiring away Polish pilots. The Polytechnic University in Rzesow, Poland's only school for training commercial pilots, graduates only 15 pilots each year. Poland's military pilots, unlike those in the United States, are not trained to civilian standards and must go through flight school again to be certified to fly civilian passenger aircraft. The F-16 pilots being trained in the US (to a better US standard) will be available only after many years when they leave the military. For these reasons, LOT is considering partnering with the Rzeszow Polytechnic to double the annual output of pilots. However, this is expensive, since it costs about \$600,000 to train a commercial pilot.

16. (C) LOT's pilots are well aware of the shortage and are using it to press for higher wages. LOT pilots currently earn about 70 percent of the Lufthansa scale, which is not bad considering the difference in the cost of living between Germany and Poland. In contrast, Polish flight attendants are much cheaper than their Lufthansa counterparts, giving LOT an overall labor cost advantage over its West European competitor. LOT would like the Polish Air Force to modify its training program so that it also meets the civilian standard. However, the military is resistant. Military pilots who currently leave the Air Force at the age of 40 would still have decades of potential employment as pilots if they were civilian certified.

Route Strategy

17. (C) Poland would like to capitalize on its eastern EU location to serve as a gateway for European flights to Asia. Currently, Polish passengers flying to Asia must fly west to Frankfurt before heading east again. Once regular flights to Asia are established, Warsaw could serve as a hub for Western European passengers flying east, similar to Helsinki today. LOT is thinking about establishing a charter service to Phnom Penh this winter, based on existing traffic. LOT currently does not make money on its transatlantic flights, due to low discount pricing introduced last winter by the previous management. Poles planning long-distance trips buy their tickets long in advance. They took advantage of a cheap LOT promotions in February to fly in the summer. Adamski said LOT's faulty pricing strategy, now corrected, meant that its flights to Toronto, New York, and Chicago all lost money this summer.

18. (C) Finance VP Tyrajski said LOT also loses money on all but two of its domestic routes. Only the Warsaw-Gdansk and Warsaw-Wroclaw routes are profitable. The new flight from Rzeszow to the US introduced for the summer travel season was not a particular success. However, Rzeszow area politicians are pressuring the airline to keep up the service year round. LOT is considering keeping on one flight a week from Rzeszow if the passenger traffic justifies it. But Rzeszow authorities are not happy with this and are threatening to bring in low-cost competition. LOT's most profitable routes are currently to Germany (Frankfurt, Munich, and Hamburg), which is ironic given its strained situation with Lufthansa.

Warsaw Airport Terminal

19. (C) LOT believes that the long-delayed new Warsaw Airport terminal will finally open for business in fall 2007. The terminal's opening has been held back due to various minor technical problems, including the reach of the public address system, which must be audible in all passenger areas in the event of an emergency. In Adamski's view, the project schedule was also disrupted by the disagreements between Budimex and the Airport Authority, over contract costs. In Adamski's view, Budimex low-balled the bid in the hope that it could win the tender and later charge more for subsequent design changes. However, the Airport Authority has been sticking largely to its original plans. Furthermore, Budimex priced the contract in dollars rather than Euros, while its costs are in Polish Zlotys. The steep decline in the dollar means that the company is losing a lot of money on the project. Furthermore, Budimex's reputation as a reliable partner has been hurt. Adamski said the company will now probably lose out on the airport renovations planned in

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Ukraine, for example.

Comment

110. (C) Adamski has been with LOT for many years and was quite open with us about the issues the airline faces. He repeatedly emphasized how central the delivery of Boeing 787's is to the future of the Polish carrier and how essential it is to get it right. LOT is one of the European launch customers for the 787 and it expects to use the arrival of the new aircraft to boost its image among both passengers and potential investors. The airline is currently under intense pressure from low-cost EU rivals (Ryan Air, German Wings, Wizz Air etc...) for its tourist passengers, and from big EU carriers (e.g., Lufthansa) for its business traffic. Tyrajski was coy about discussing LOT's profitability, but he tried to leave the impression that the airline could deal with its problems. Given LOT's complex structure as a holding company with several different sub-companies (and the possibility of shifting costs through

internal company transfer pricing), it is not easy for an outsider to gain a clear picture of its real health.

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